



Investment Commentary: Small Cap Q1 2025

How *American* Is Your US Portfolio?

Markets have been rattled by tariff threats. And while President Trump's announced a 90-day pause on tariffs for most countries, the tariff saga is far from over. For investors, understanding the risks and opportunities tariffs pose to their portfolios is critical.

Tariffs pose challenges not only for multinational companies with significant foreign revenue but also for firms heavily reliant on foreign suppliers—especially in the technology and industrial sectors. While small-cap companies typically generate less revenue abroad (20% for the Russell 2000 vs. ~40% for the S&P 500), their supply chains often depend on foreign components. With tighter margins and limited pricing power, small caps face particular vulnerability.

Q1 Performance

The strategy returned -7.7% in Q1, outperforming the Russell 2000's -11.1%. Through April 10, year-to-date performance stands at -10.8% vs. -17.3% for the index. The team credits this outperformance to portfolio quality, including:

- Cash Flow ROI: 16.5% vs. 7.8%
- Average Leverage: 8.7% vs. 21.0%
- Default Probability: 0.0% vs. 3.7%

Since its 2015 inception, the strategy has delivered a 10.5% annualized return vs. 7.1% for the Russell 2000—resulting in 4.3% annualized alpha thanks to higher returns and lower volatility.

Tariff Risk Assessment

1. Revenue Exposure:

An in-depth review revealed only 11% foreign sales across the portfolio—far below the Russell 2000 average of 20%. These sales are typically to trade-friendly regions and stem from companies with high ROIs and the resilience to absorb margin pressure.

2. Supply Chain Risk:

Supply chain vulnerability was analyzed across holdings, with risk scores assigned and vulnerable companies stress-tested. Adjustments were made where necessary to reduce exposure to tariff-sensitive supply chains. See the next section for an example.

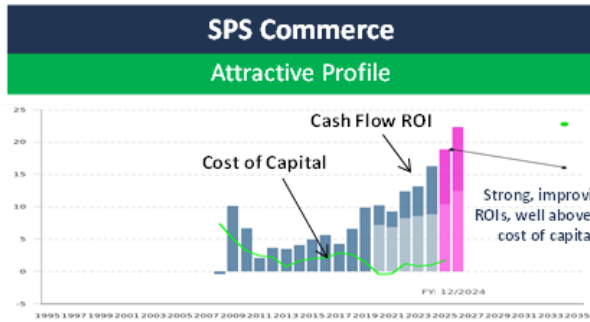
3. Quality Focus:

Many small caps are unprofitable or overleveraged, making them susceptible to even minor margin compression. Our strategy avoids such risks by maintaining a strict focus on high-quality businesses—profitable, well-managed, competitively advantaged, and conservatively capitalized. No exceptions.

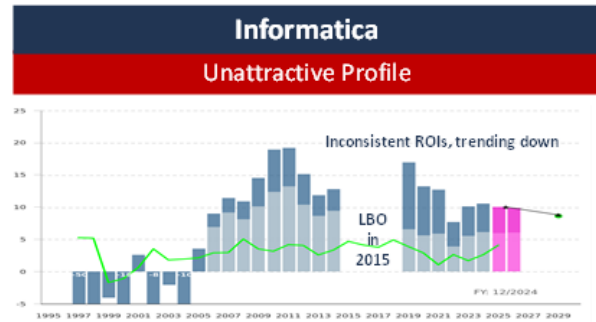
Recent Trades & Examples

The portfolio was initially overweight industrials—a sector prone to tariff impacts due to foreign-sourced inputs. In response, we trimmed weaker industrial names during the quarter and added to SPS Commerce (SPSC), a provider of cloud-based supply chain solutions poised to benefit as companies restructure operations in response to trade policy. The Cash Flow ROI chart for SPSC is presented below and compared to one of its competitors, Informatica (INFA). Clearly, SPSC has the stronger profile.

SUPPLY CHAIN SOFTWARE



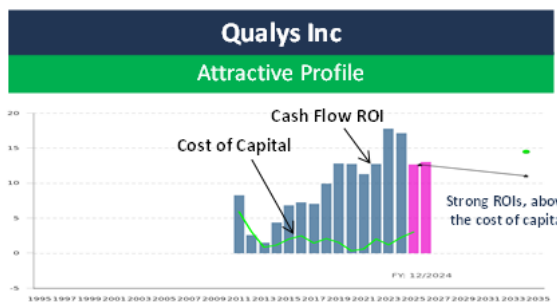
SPSC has *outperformed* the market 3x since it went public



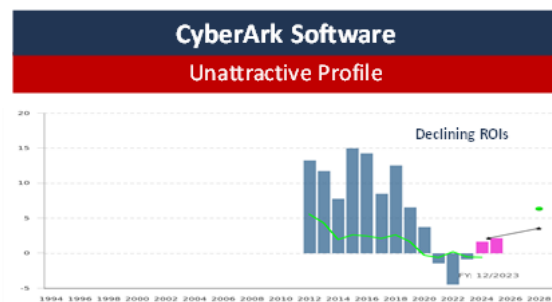
INFA has delivered 40 cents on the dollar since its IPO in 2021

We also favor **Qualys Inc. (QLYS)**, a cybersecurity firm offering supply chain risk management tools. Compared to a peer like **CyberArk (CYBR)**, which has struggled with profitability and trades at a PE of 107x, Qualys offers steadier growth (7–8%) and a much more reasonable valuation (20x PE).

CYBERSECURITY EXAMPLE



QLYS has *outperformed* the market nearly 2x since it went public



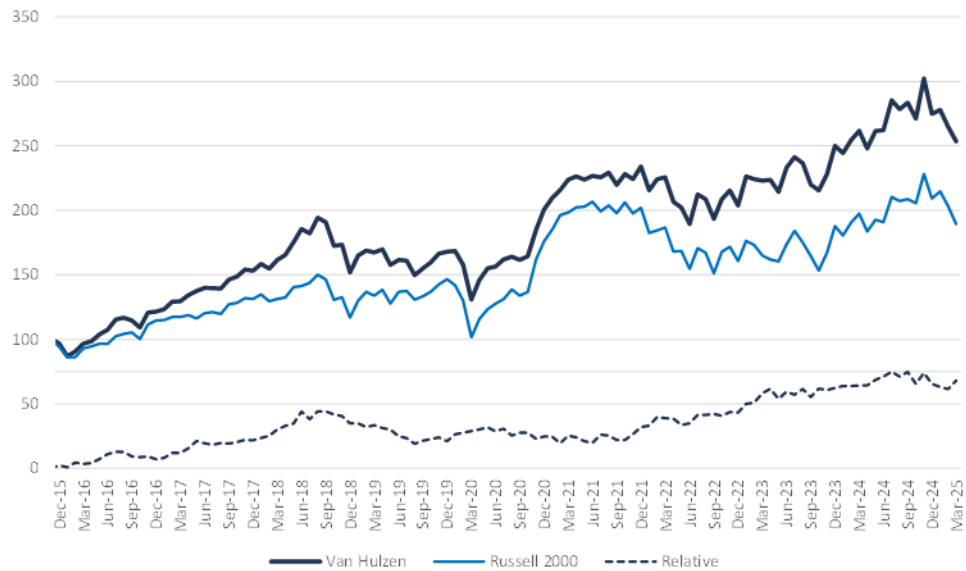
CYBR lost money in 2024; has a PE ratio of 107x

Note: Above charts from UBS HOLT™

Long Term Performance

With an annualized return of **10.5% vs. 7.1%** for the Russell 2000, the strategy has produced over **4% annualized alpha**. The team attributes this success to a disciplined research process focused on:

- Strong Return on Capital
- Above-Average Growth
- Low Debt and Default Risk



Alpha		
$a = R_p - [R_f + (R_m - R_f) \beta]$		
	Russell 2000	S&P 600
Rp = Realized return of portfolio	10.5%	10.5%
Rm = Market return	7.1%	8.3%
Rf = risk-free rate	1.8%	1.8%
β = Beta	0.82	0.82
Alpha (relative to RUT)	4.3%	3.3%

Outlook

The environment remains uncertain. Small caps initially surged post-election amid hopes for deglobalization and rate cuts—but with trade tensions escalating, inflation and margin pressure are real risks. Historically, inflation hurts small caps. That said, when the rotation does arrive, we believe high-quality small caps will lead.

Key Takeaways

- The portfolio outperformed the Russell 2000 in Q1 and continues to do so in Q2.
- Tariff risks have been assessed and addressed through strategic portfolio adjustments.
- A small-cap rebound may be delayed, but is still expected due to:
 - A wide valuation gap between small and large caps
 - Continued rate cut environment, which historically favors small caps
 - Long-term tailwinds from deglobalization and onshoring
- The portfolio remains focused on **high-quality, low-debt, cash-generating companies**—a strategy that has delivered consistent outperformance for more than nine years.

APPROACH

The strategy uses a “Growth At A Reasonable Profile” approach, which basically means we are not speculative. Just like you’ve come to expect from us in the large cap space, our focus is on quality first. But in the small cap space, we are just as open to growth and momentum stocks as we are value stocks. A “reasonable profile” means the business must be established and already profitable, earning returns above its cost of capital. Beyond these simple parameters, we look for companies that are leaders in their industries, expanding rapidly (2-3x the market), and consistently beating expectations for growth.

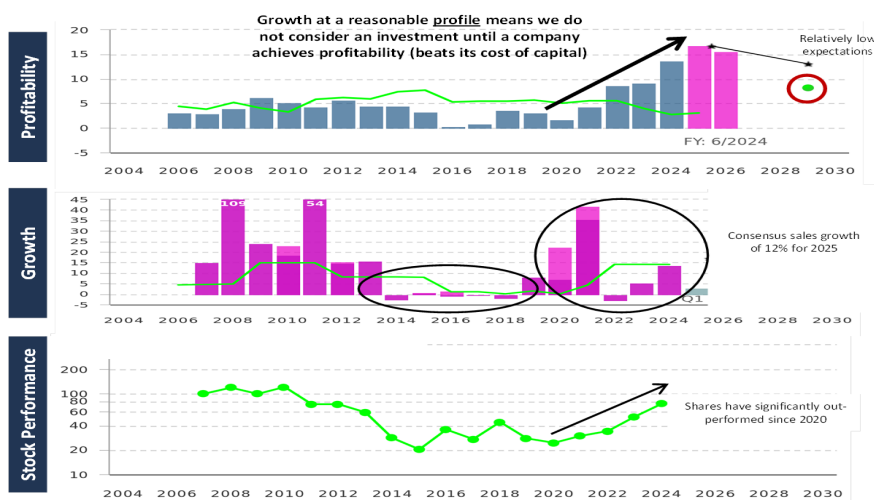
Portfolio Construction

Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with market caps between \$1-5 billion and have a below average portfolio turnover profile.

Fundamental Analysis

Fundamentals come first. Always. But we also incorporate technical analysis into our investment process, to provide key downside/support levels and also to provide confirmation of buy/sell signals. Small-cap stocks can be volatile and technical analysis provides information into position sizing, entry and exit decisions and can trigger due diligence reviews.

To better understand our investment approach, consider one of our holdings: Stride Inc (LRN). Stride provides online curriculums and software systems in the education services industry. It is a high growth company with great momentum and, we believe, plenty of room for further upside.



Source: Credit Suisse HOLT

Key Points

- Market cap: \$4.8 billion
- Strong & improving Cash Flow ROI, above average for the sector.
- Future ROI priced into the stock price (green dot on right side) very low relative to current levels.
- Management restructured the business in 2014-2018, when it was unprofitable...
- Company is back in growth mode now.
- Investors have applauded the shift towards profitability
- Shares have outperformed the index nearly 4-to-1 since 2020
- We believe the shares are still undervalued

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